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CIO Viewpoint

Japan's path to normalising monetary policy

Investment Solutions

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With improving economic prospects that may outpace growth in the US and Europe in 2023, Japan is on a slow path to monetary policy normalisation. Still, the Bank of Japan (BoJ) has surprised markets as an outgoing governor navigates a path to change a more than six-year old strategy. We look at the road ahead for the world's third-largest economy.

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Japan's economy is looking relatively healthy. It has been less affected than Europe and the US by inflation, the war in Ukraine and energy market volatility. Its biggest export market, China, is reopening, promising a further boost. We expect the country's gross domestic product to expand by 1.6% over 2023, with average consumer inflation reaching 2.5%, on the back of significant hikes to electricity tariffs. This is some way above market consensus estimates, and the central bank's target for the second year running.

However, Japan's economic growth is driven largely by consumer demand, so much depends on wages keeping pace with inflation, which by Japanese standards is exceptionally high. Two decades of low earnings growth has made workers sensitive to rising prices. The annual round of industrial wage negotiations that start in February/March, known as 'shunto,' will therefore be closely watched. Japan's largest federation of trade unions asked for a 5% rise in total pay in November (3% increase in base pay and a further 2% rise for more experienced workers) but its initial demands are usually watered down. Meanwhile, Japanese fashion brand Uniqlo said it would raise wages by an average of 15% from March. A 3% wage increase – the highest for some years – would bring salary growth to the level that the BoJ said in 2022 would be sufficient to generate a moderate and sustainable level of inflation. The first batch of the negotiation results will be released in March and provide the first clue on how workers' pay will behave this year.

BoJ's December surprise

Along with very low inflation, Japan has had very loose monetary policy for more than six years. The BoJ also initiated its 'yield curve control' (YCC) policy in September 2016, setting its target yield for the 10-year Japanese government bond (JGB) to zero with a tolerance band of plus-or-minus 0.1 percentage

Key takeaways

- Japan's economy looks relatively healthy, giving the BoJ an opportunity to wind-down its yield curve control policy in place since 2016
- Policy evolution depends on domestic demand, and in turn, wages keeping pace with inflation. Wage negotiations will be closely watched
- We think the BoJ's next move will be to strengthen short-term rate guidance and bring its yield curve policy to an end. It will have a new governor in April
- We are positioned to benefit from rising Japanese domestic demand, which would favour small and mid-cap stocks, and we see the yen strengthening to trade around USDJPY 120 by the end of 2023.

points. The bank widened this tolerance band over the following years incrementally to ±0.5 points in December 2022 (see chart 1). Markets have struggled to predict these changes, especially in the case of the initial YCC adoption, and the latest move to widen the band.

Markets interpreted the BoJ's surprise December move as a signal that it was planning to reduce the scale of its policy accommodation. There is now speculation that it will abandon its defence of a specific yield level for 10-year JGBs entirely, but uncertainties remain on the precise nature of the next policy move. Markets were again surprised by the lack of action in January's BoJ meeting. Such unpredictability does not seem to concern the BoJ's leadership. "No central bank tells the market what they are going to do in advance of policy meetings," Mr Kuroda said on 18 January. "There's no need for central banks and the market to have exactly the same ideas."

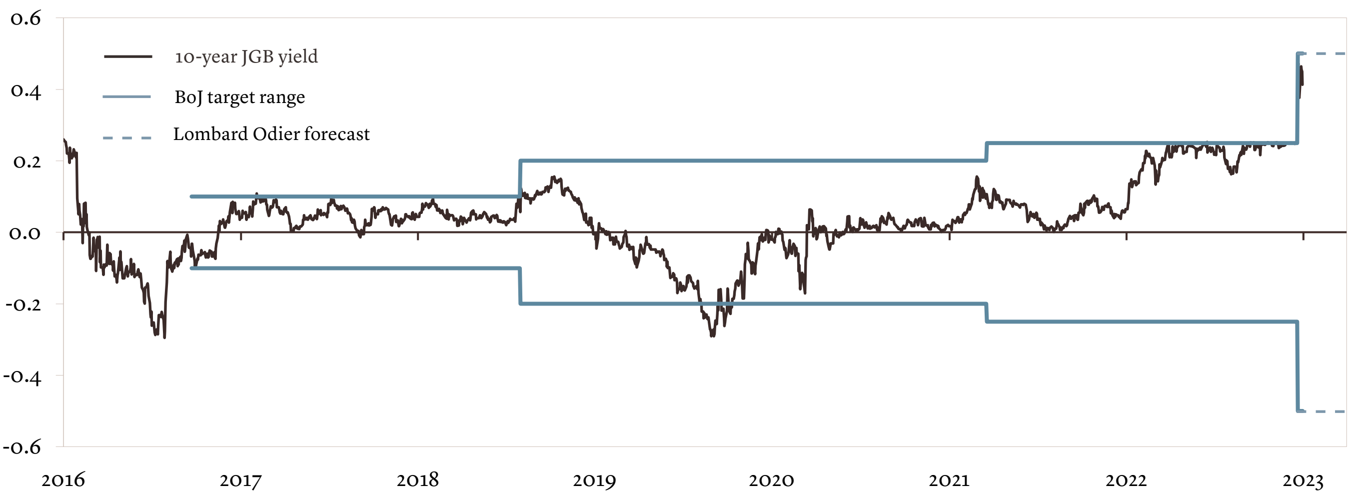
Initially adopted as a technical complement to its negative interest rate policy, the BoJ's YCC strategy became a source of significant political discomfort for both the central bank and the government. This is because it has tended to amplify currency market moves in times of global bond yield volatility. The pledge to keep the 'upper bound' of the tolerance band for the YCC, for instance, requires the BoJ to make large purchases of JGBs if bond market sell-offs threaten to push yields above this level. This pro-cyclical nature of the policy was on display in 2022 when the bank had to inject unlimited liquidity into the country's bond market, despite the historic depreciation of the yen.

If there were a good time to drop the BoJ's YCC policy, this looks like it. Logically, and in our base case scenario, the next step would be for the BoJ to strengthen its short-term rate guidance and remove the YCC policy, letting markets price long-dated sovereign bonds based on short-term rates, like other central banks. Alternatively, it could pursue other forms of easing: target 5-year instead of 10-year target, widening the 10-year band or making the upper bound less binding. In the current environment, it would make sense to widen the yield curve again only if upward pressures on bond yields ease significantly. If not, it would potentially widen the band only to defend the new upper bound with unlimited JGB purchases, as it has since its December decision to set the band at ±0.50% (see chart 2).

The likely sequence for the BoJ's 'normalisation' path thus involves the removal of the YCC policy followed by more conventional monetary policy guidance for short-term rates, depending on the development of inflation and wages. We do not expect any change before April, when Mr Kuroda departs and the fiscal year ends. Doing so beforehand would mean large investors such as pension funds and financial institutions could see big swings in valuations of their JGB holdings. If conditions continue to point to on- or above-target inflation, the BoJ may end its negative interest rate policy, though not any time soon. We believe that an adjustment in short-term rates is still unlikely this year.

1. The BoJ has widened the YCC band three times since its adoption in 2016

BoJ's tolerance band for its yield curve control and market yield, %



Sources: Bloomberg, Lombard Odier

BoJ leadership and candidates

Attempts to anticipate BoJ policy are complicated as Governor Kuroda's ten-year term ends in March 2023. Until now, two names have been regularly mentioned as successors to take over at the BoJ's April meeting: Deputy Governor Amamiya Masayoshi, or his predecessor, Nakaso Hiroshi. A third candidate and another former deputy, Yamaguchi Hirohide, is now being mentioned. Mr Yamaguchi's stance is clearly more hawkish. He is known as a critic of the BoJ's monetary stimulus and has warned that domestic inflation expectations are in danger of becoming entrenched, pushing wages and long-term rates higher. Mr Yamaguchi warned last month that it would be dangerous to abandon YCC in a single step, and that it would make more sense to gradually increase the 10-year yield target. We see Mr Amamiya as Mr Kuroda's most likely successor, instilling a measure of continuity. The BoJ may also appoint a female deputy governor, helping stave off criticism of a lack of gender diversity in its raft of top candidates.

From a procedural point of view, the timing of the next governor's first meeting will fall once the results of the national wage negotiations are complete. Whoever takes over from Mr Kuroda faces difficult choices; the central bank's YCC policy has been unpopular politically as it has contributed to a weaker Japanese yen, increasing levels of imported inflation. The appointment will be made by Prime Minister Kishida Fumio, and whichever candidate succeeds Mr Kuroda, our expectation is that the BoJ will eventually move away from extraordinary monetary stimulus measures and abandon yield curve control.

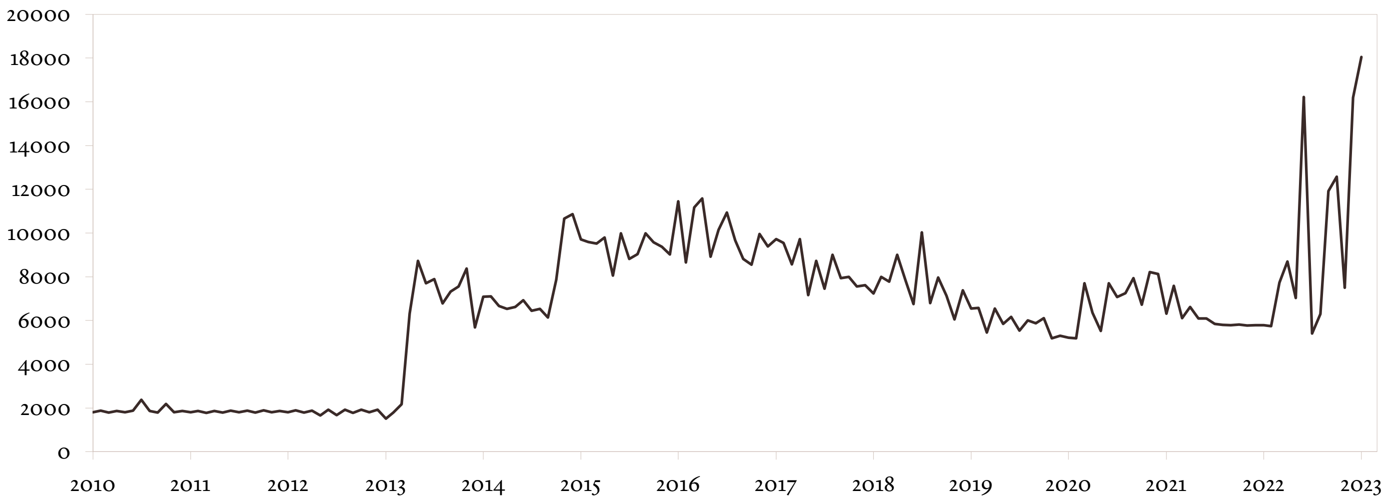
Currency markets, equities

In 2022, a weakening yen and more competitive exports helped support Japanese equities. This year, however, we see the yen strengthening against the US dollar, with the USDJPY trading around 120 by the end of 2023, from today's 130. The US Federal Reserve is slowing the pace of rate hikes while the BoJ tightens policy. The yen is also benefiting from the economy's improving terms of trade. It increasingly looks like an attractive alternative haven currency to the dollar.

A change of dynamic for the yen will have implications across markets, with a tailwind for Japanese equities becoming a headwind in 2023. In light of this, we favour sections of the market more focused on domestic demand than exports. We shifted our Japanese equity allocation from large cap to small and mid-cap stocks in November 2022. The latter stand to benefit more from Japan's improving growth outlook, as well as from increased foreign tourism and a stronger yen that would reduce the cost of imports. Specifically, we favour regional banks, real estate, transport, leisure, consumer discretionary stocks, and internet service and content providers.

2. The BoJ was forced to buy more JGBs in 2022

Monthly change in BoJ's JGB purchases, JPY billion



Sources: Bloomberg, Lombard Odier

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